FTA
FINANCE & TREASURY ASSOCIATION

Friday 15 June 2012

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Re Implementation of a framework for Australia's G20 over-the-counter derivatives commitments - Response to consultation paper by Finance and Treasury Association.

Overview

The Finance and Treasury Association welcomes this opportunity to consult with Australia's financial regulators on a matter which cuts to the very heart of the activities of our membership of corporate treasurers and financial risk managers.

(For simplicity's sake and for the purpose of reinforcement, we have incorporated and highlighted key principles, directly from FTA's submission to the OTC Derivatives Central Clearing Consultation conducted by the Reserve Bank of Australia on behalf of the Council of Financial Regulators in September 2011.

http://www.rba.gov.au/payments-system/clearing-settlement/submissions-received/central-clearing-otc/pdf/fta.pdf)

Following the global financial crisis, there was a period a **lack of confidence in the OTC derivative market's capacity to be effective in dealing with the stresses of the market.** At this time there was a market–wide concern that notwithstanding **well-developed bilateral risk management conventions and arrangements** a default of one institution could have a significant systemic effect on other institutions (although it is important to note this did not

occur, despite the collapse of a number of financial institutions). Concerns over the lack of transparency and risk management resulted in regulators initiating reform in the OTC derivative market.

FTA recognises this consultation is designed to put in place institutional arrangements which would allow Australia to quickly integrate with the rest of the world in line with Australia's G20 commitments. Moreover, FTA sees that the international situation is moving rapidly. Hence FTA considers it constructive that Australia's initial proposals are fairly flexible at this stage in, for instance, not making central clearing mandatory for now.

FTA acknowledges that **central clearing** provides a central point for market oversight and participant default management, bringing with it a perceived increase in the resilience of financial markets. However, it also brings a rigidity and concentration which may prove counterproductive to the intention to reduce systemic risk.

FTA considers **exchange trading** of derivatives if broadly adopted will largely negate the benefits of over-the-counter trading such as the ability to tailor prudent risk management strategies for non-standardised economic risks.

With trade repositories, FTA considers there are some risks to corporate treasurers under the new arrangements, such as the possibility hedging strategies in some form may become more publically available. And we would expect buy-sell spreads would widen substantially if trades are reported in real time as has been proposed by the US. As discussed in the detailed responses, FTA is concerned that the consultation paper provided little clarity about who will have access to the information and how the information might be used.

FTA would also be concerned if the same "Too Big to Fail" Big 5 banks which currently control the OTC market might also control the new infrastructure – although FTA's view is they should pay a share corresponding to their dominant market share.

FTA's primary concern is that prudent corporate risk management not be made prohibitively expensive nor administratively unworkable. FTA considers deals done by non-financials to be a tiny part of the derivatives markets here and abroad, and therefore not material in their impact on systemic risk. However, it is our contention that requiring the collateralisation of corporate OTC derivatives transactions will together with the Basel III reforms lead to an unintended consequence of dampening investment which will **impact on the real economy**.

We note that the purpose of the G20 reforms is to address systemic risk hence the application of these rules to the corporate sector may be a classic "sledgehammer and nut" situation. Deals done with non-financials are small in number and of notional value relative to the banking sector exposures which are the target of the regulation. Corporate hedging transactions are

unlikely to have system-wide impact and are done with a diverse range of companies so are so less liable to correlation and contagion.

Moreover, company transactions are by and large hedging commercial risks so they tend to be tailor made and not so suitable for standardisation and clearing. And to the extent that hedges are measured to be "hedge effective" in an accounting sense, any gains and losses on a hedging transaction will have an equal and offsetting loss or gain from the risk being hedged and so in systemic terms are not as risky.

Please note that FTA does not consider accounting definitions of hedging to be appropriate as a necessary condition. Accounting hedges can be treated as automatically being valid hedges for derivative legislation purposes but there will be many other transactions which are commercial hedges even if they do not officially meet the rigorous accounting tests. And many companies for valid reasons choose not to apply hedge accounting even though some of their deals might be suitable to pass the tests. The key is that economically-effective hedges not be penalised.

As stated in FTA's submission to the OTC Derivatives Central Clearing Consultation last year, a move to central clearing of OTC derivatives will likely bring additional cost to corporate participants (if not exempt). Mainly of concern here is the requirement to post initial margins and additionally the obligation of ongoing margin calls where no current collateral requirements exist. The effect to a corporate's cash flow along with the additional fees and interest expenses will discourage the use of these derivatives by corporations to manage unintended risks in business operations, potentially exposing them to increased risk through unhedged adverse market movements as an unintended consequence.

One mechanism by which mandating central clearing and margining on companies will impact on the real economy is it would remove credit risk from the financial system and instead transfer liquidity risk onto companies. This liquidity risk is virtually unmanageable currently for companies without them taking out significant extra bank funding facilities. **This would defeat the purpose of the exercise as every company would need to have bigger banking lines with much greater flexibility. In total this would be far more inefficient for the economy than having banks grant credit exactly matching the size of exposures arising from derivative deals.**

The key recommendation of this response like FTA's prior submission is for there to be an exemption for corporations which undertake both vanilla and non-standardised OTC derivatives for hedging and risk management purposes.

In addition FTA sees merit in a "carve out" for all non-financials including superannuation funds with positions below a certain threshold to be exempt from mandatory clearing. We suggest that in calculating if the company has passed a threshold, that transactions done for "hedging" purposes are not counted. We understand that the definition around "hedging" may be still up

for debate. We suggest that **hedging involves "contracts that are objectively measurable as reducing risk directly related to the commercial activity or treasury financing"**. This would be consistent with Europe.

Corporations' use of Financial Derivatives

Corporations are large users of financial derivatives in Australia. **These transactions are primarily used to manage financial risk positions created through their ongoing business operations** or their capital market activities (primarily the sourcing of capital). As a result of these types of activities, corporations are primarily 'price takers' of financial derivatives, being either buyers or sellers of positions (based on their underlying business), rarely both, hence their **gross financial derivative positions are largely the same as their net financial derivative positions, hence receive little benefit attributed to the large financial institutions from netting.**

The manner in which these transactions are used means they are a critical tool for mitigating risk and not creating risk. To date these transactions have been typically made available to corporations on a credit line basis either without direct security being required or when required being able to be provided in a number of different forms. For example, under current collateralisation agreements such as Credit Support Annexes, corporate entities are quite often able to provide bank guarantees, letters of credit or securities as collateral and hence are not required to draw down on either working capital or debt facilities.

The cash outcomes of these hedging financial derivatives do not occur until the maturity of the exposure being managed i.e. hedged occurs, however, if margining is required throughout the transaction's life, this could create a significant impost on corporations and a disincentive to use an effective risk management tool. In contrast to large derivative market participants who trade these instruments, as mentioned above, corporations' financial risk management transactions are 'one directional' and they do not receive any netting relief.

To explain what corporate hedging involves it is worth considering an example.

If a company is expecting sales proceeds denominated in a foreign currency next year it can take out a **forward FX deal** now to create certainty as to the amount of local currency it will receive. Thus hedging creates certainty as to profit and cash flow. During the time until next year the value of the forward deal will change but the company does not mind this because there is an equal and opposite change in the value of the foreign receivable too. There is no cash effect during the life of the hedge. However were the change in value of the derivative to be margined the company would have to find cash now and throughout the year, to put up the collateral. In other words the hedge done to eliminate the future cash flow and profit volatility would instead be creating a volatile cash flow during the life of the hedge. Most companies would not have the cash or borrowing capability to cope with this.

Another commonly used instrument is the **cross currency swap** which is used by treasurers to **source funding from abroad while removing currency exposure risk.** Larger companies are able to raise competitive funding in overseas markets which can then be swapped back into AUD. If the effect of regulation is to make the cross currency swap excessively expensive or to impose an unmanageable obligation to put up collateral there would be negative implications for economic activity. **Australia is a net capital importer with an under-developed corporate bond market which would not in the first instance be able to absorb the likely surge in domestic funding requirements if cross currency swap were made unworkable.** If funding is more expensive, or at worst is not even available in sufficient amounts new investment opportunities might become financially unviable.

As stated above, corporations utilise financial derivatives as cash flow hedges for their underlying business activities. **The requirement to provide margin to a central clearer would place the effectiveness of these hedges at risk and could create significant accounting implications and unnecessary volatility in financial reports.**

Based on developments in other jurisdictions, FTA understands corporate hedging is likely to be exempted (so long as the company is not considered to be a swap trader) from the requirement to centrally clear in other jurisdictions. We encourage the local regulators to adopt a similar approach in Australia. **Additionally, should corporations be forced to use standardised contracts the commercial match against their exposures could be imperfect, a problem in its own right, and their ability to receive hedge accounting treatment in the accounts would be inhibited.**

As stated in our 2011 submission, we understand the imperative in the local market to set regulation for a central clearer to ensure the Australian capital markets remain competitive. However, **we do not believe the establishment of a central clearer will provide any benefit to Australian corporations, and may in fact impose additional costs on the use of financial derivatives, potentially driving a two tier pricing regime, prices for organisations who centrally clear and those which do not.**

We do however note that if corporations are exempt, financial institutions may lose netting benefits potentially increasing the cost of providing these transactions. For this reason, corporations would be concerned if there were multiple clearing houses which financial institutions may be required to use (say onshore and offshore) as this would also have the impact of diluting the ability to net.

It may be argued corporations may benefit from reducing their exposure to providers of financial derivatives, typically the local and international banks, **by replacing them with a central clearer; however, this would be largely ineffective.** The credit relationship corporations have with providers of financial derivatives are typically two way as those same institutions are also often providers of capital, hence netting the risk for the corporations.

However, shifting this to a central clearer removes this benefit and replaces it with another credit exposure, that to a central clearer. Additionally we may find the growth of bundled solutions, combining debt capital with derivatives as one structure, while potentially being cost and credit effective will reduce flexibility and transparency, detracting from corporations ability to bifurcate the management of their liquidity and market risk (primarily interest rate risk), as per the currently accepted corporate governance approach.

Based on the balance of implications outlined above, the key recommendation of this consultation response, as for FTA's prior submission, is that Australia's financial regulators develop an exemption from mandatory clearing requirements for corporate entities using derivative products purely for financial risk management purposes or "Hedging". **In other jurisdictions, exemptions are likely to apply to many corporate end users and smaller market participants, in part because of the smaller effect on systemic risk made by these entities.**

For Australian entities **an appropriate exemption would protect the non-standardised way corporate entities trade OTC derivatives. The exemption would eliminate margining and additional transaction costs to ensure that hedging remained an economic way to decrease business risks.** To ensure this a conscious effort by regulators should also be made to restrict financial institutions from passing through their additional liquidity costs to corporate entities through unfavourable pricing.

In the consultation document you have asked for some specific questions to be answered. We have provided a response to those which we believe relate to corporations, other non-financial enterprises and pertain to real economy impact of the proposed regulation.

Q5. Do you agree that non-discriminatory access requirements should be imposed on eligible facilities?

Yes, provided that the market participant meets appropriate risk management standards which these facilities must maintain as part of their primary responsibility.

Q6. & Q33. Do you have any comments on the rule-making power that will be available to ASIC?

FTA recognises the need for quick implementation given both our G20 commitments and the need to minimise market disruption. Yet some of our members have concerns about giving effective policy-making to ASIC given its traditional enforcement focus. We are also concerned about overreach in implementation of extra-territorial laws although the Australian OTC market has long accepted international laws and standards. With this reservation we encourage Treasury along with the Reserve Bank to retain discretion. So long as the primary legislation

clearly defines objectives and outlines some of the methods to be used we would expect it to be workable for the detail to be filled in by ASIC.

Q9: Although the possible counterparty scope is set broadly, should minimum thresholds for some or all types of counterparty be set by regulation, so that no rule that is made will ever apply to those counterparties (unless the regulation is subsequently changed)?

FTA considers there is a need for an exemption for corporations which undertake both standard and non-standardised OTC derivatives for hedging and risk management purposes. The key recommendation of this response like FTA's prior submission is for there to be an exemption for corporations which undertake both standard and non-standardised OTC derivatives for hedging and risk management purposes.

In addition FTA sees merit in a "carve out" for all smaller non-financials including superannuation funds with positions below a certain threshold to be exempt from mandatory clearing. **We suggest that in calculating whether the company has passed a threshold, transactions done for "hedging" purposes should not be counted.**

We understand that the definition around "hedging" may be still up for debate. We suggest that hedging involves "contracts that are objectively measurable as reducing risk directly related to the commercial activity or treasury financing".

Q10. **From the point of view of your business and/or of your clients, do you have concerns around any 'back loading' requirements? For example, are there any problems with obligations applying to transactions that are outstanding at the time the rule is made?**

FTA considers any retrospectivity is not desirable although it is arguable that for the trade repository to be useful, the capturing of information about existing contracts may be useful, if not necessary. (The answer to this question and others on the trade data depository relate to how useful will be the entire data set once collected; we address this below.) Notwithstanding our contention that corporate hedging transactions be exempted, we also consider back loading undesirable if it means counterparties must find collateral for all old transactions.

Q13.3 What is an appropriate threshold to exempt end users from the mandatory obligation to report OTC derivatives transactions to a trade repository or regulator?

FTA understands that in Europe all transactions have to be reported to a trade repository or regulator although there is no clear view of which measure would be most meaningful. How do you measure such a threshold, number of transactions, notional value, net value or hedge

effective value? Probably the number of deals or cumulative notional would be easiest to measure.

FTA proposes banks be required to do most of the reporting and to bear such additional costs as an industry.

If banks do not offer the service then companies would need a heavy investment in systems of their own

Q16. Do you agree with the option of relying upon market forces and a range of other mechanisms, such as capital incentives, while monitoring the impact of such mechanisms in systemically important derivative classes and providing for possible future mandating, to ensure that central clearing becomes standard industry practice in Australia within a timeframe that is consistent with international implementation of the G20 commitments? If not, is there another option you prefer?

A previous group of financial regulators allowed market forces to determine risk weighted capital adjustments under Basel II. Clearly there were deficiencies in this process which is one reason we are getting the Basel III capital rules which add an extra and fairly punitive capital requirement onto uncleared derivatives, arising from the "CVA", credit valuation adjustment. CVA attempts to allow for the change in value of a derivative as the credit worthiness of a party deteriorates.

Letting market forces encourage central clearing, while good in principle, would be trumped by the proscriptive aspects of Basel III. Clearly, as much as possible regulators need to take account of overlapping regulations.

Q 18. Are there specific classes of transaction that should be excluded from the potential reach of trade clearing DTRs?

18.1. In particular, should some transactions entered into for certain purposes (for example, hedging, commercial risk mitigation) be outside the potential reach of the rule-making power?

FTA agrees it would be appropriate to only apply the clearing obligation to certain types of transactions and certain types of entities. In particular, an exemption from the clearing obligation should apply for hedging or commercial risk mitigation transactions whether using standard or non-standard OTC derivatives.

Non financials, especially when doing hedging, do not contribute materially to financial system risk so should be given an exemption.

By the same principle, intra-group trades by non-financial corporations should also be excluded from central clearing rules.

Q 20. Do you consider that there are any OTC derivative classes for which an execution on trading platforms mandate would be appropriate at this time? If so, please provide any evidence which supports your view?

In our previous submission, FTA argued 'vanilla' interest rate derivatives which are traded using common market variables, such as frequency of payment, payment term, term to maturity, principal amount for instance, could be effectively cleared. These transactions are generally traded in the interbank market and they could be exchange traded.

However for the corporate hedgers, transactions are typically structured to meet specific hedging requirements (of corporations), and hence would not have consistent features and would be more difficult to clear, let alone trade on an exchange.

As detailed in the section, "Corporations' use of Financial Derivatives", currency related transactions present even more difficulties to clear, particularly as their settlement is often not netted.

FTA does not see any merit in hurrying to mandate execution of 'vanilla' interest rate derivatives on trading platforms.

Q22. If a derivative class is prescribed for mandated use of CCPs should it also be mandated for execution on a trading platform?

FTA considers the two concepts are achieving different things hence it does not follow automatically OTC exchange trade execution should be mandated if use of CCPs has been.

Q25.4. Should the prices and sizes of individual transactions reported to trade repositories be made publicly available? If so, do you have any views on the time frame in which the information should become publicly available? Should there be different time periods for public release of transaction data depending on the size of particular transactions?

FTA members feel strongly OTC trade repository information on corporate hedging should only become publicly available with a significant lag measured in months and on a "no names basis" and only in such instruments where names could not be determined by nature of data released. FTA considers there to be **a risk of breaching of commercial-in-confidence arrangements between corporate and bank**. Furthermore, it should be noted the market

would likely move against any large positions so notified and this may distort pricing against the customer.

Q26. Would Australian market participants support a domestic trade repository as an alternative to an international trade repository, recognising there are likely to be cost implications in establishing and maintaining a domestic trade repository?

FTA sees trade repositories as an inevitable cost burden and considers it may be appropriate there be a domestic trade repository in Australia eventually for interest rate forwards and swaps between Australian banks. However we recognise much of the market is already effectively cleared offshore and also see potential cost reduction benefits for Australian banks from providing data to a single global data repository to decrease duplication.

Costs of data capture and dissemination could be met by levying OTC market participants and conducted on a not for profit basis.

FTA would be concerned if the same "Too Big To Fail" Big 5 banks which currently control the OTC market might also control the new infrastructure – although FTA's view is that they should certainly pay a share corresponding to their dominant market share.

Q29. Do you have any initial views on the property rights in trade information passed to trade repositories?

We question how the regulators will make any sense of much of the data and would like to see an exposition of planned use of the data.

For the data to have any use it will need to be analysed and probably by multiple stakeholders such as regulators, academics and with appropriate time lags, by market participants.

Ownership of a data depository should not confer property rights to the trade information and as discussed above we propose the business of these entities be conducted on a mutual not-for-profit basis.

Q31. Do you agree with the factors identified in section 6.2 for ongoing derivatives markets assessments?

We note section 6.2 lists the information to be provided to ASIC about monitoring conditions in derivatives markets and their suitability for CCP etc. It appears not to mention vital liquidity and turnover measures explicitly but overall the list of factors is a good starting point.

FTA considers part of the process should be to consider the systemic risk caused by each class of derivative and also by each class of user. While cost is mentioned in the consultation paper, it would be desirable as with regulation impact assessments for the **full cost benefit equation** be considered. Any costs and complications end up being borne by the end user i.e. companies operating in the **real economy.** Any extra costs dampen economic activity so regulators need to be careful what they impose.

Conclusion

- Corporations are large users of financial derivatives in Australia. These transactions are primarily used to manage financial risk positions created through their ongoing business operations or their funding activities.
- FTA is particularly concerned to ensure its Australian corporate treasurer members will continue to be able to use flexible OTC instruments such as forward foreign exchange contracts and cross currency swaps.
- FTA's primary concern is for such prudent corporate risk management tools to not be made prohibitively expensive nor administratively unworkable.
- Given the potential negative real economy impact, FTA recommends if regulators are considering imposing these OTC derivative regulations on the corporate sector that they first seek to determine the full cost-benefit equation of the proposed reforms. Any extra costs and complications end up being borne by the end user and dampen economic activity, so regulators need to be careful what they impose.
- FTA does not consider accounting definitions of hedging are appropriate as a *necessary* condition to determine valid hedges. We suggest an internationally accepted definition of hedging be applied i.e. hedging involves "contracts that are objectively measurable as reducing risk directly related to the commercial activity or treasury financing".
- FTA considers deals done by non-financials are a tiny part of the derivatives markets here and abroad, and therefore not material in their impact on systemic risk.
- It is our contention requiring the collateralisation of corporate OTC derivatives transactions would together with the Basel III reforms lead to an unintended consequence of dampening investment which will impact on the real economy.
- A key mechanism by which mandating central clearing and margining on companies would impact on the real economy is it would remove credit risk from the financial system and instead transfer that liquidity risk onto companies which are not set up to manage it.
- FTA considers OTC trade repository information on corporate hedging should only become publicly available with a significant lag and on a basis where names could not be determined by the nature of data released. FTA considers that there is a risk of breaching of commercial-in-confidence arrangements.

- For Australian entities an appropriate exemption would protect the non-standardised way corporate entities access OTC derivatives as a primary risk management tool. The exemption would eliminate margining and additional transaction costs to ensure hedging remains an economic way to decrease business risks.
- FTA considers it constructive that Australia's initial proposals are flexible, for instance in not making central clearing mandatory for now.

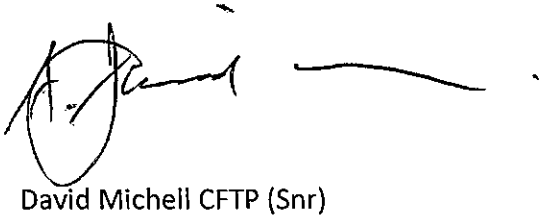
We look forward to working with the financial regulators on the next stages of the consultations and the design of the institutional framework.

Yours faithfully,

Paul Travers FFTP

President

Finance and Treasury Association



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